SCS Agency
Franchise Tax Board

SUMMARY ANALYSIS OF AMENDED BILL

Author:	Kuehl	Analyst:	Colin Stevens	Bill Number:	AB 2692
Related Bills:		Telephone:	845-3036	Amended Date:	4/29/98
		Attorney:	Doug Bramhall	Sponsor:	

SUBJECT: Depreciation Deduction/Ultra-Low Emission Vehicles Have a Class Life of 3 Years and Expense Leased ULEVs

_____ DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended _________.

__X__ AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

__X__ AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced FEBRUARY 23, 1998.

__X__ FURTHER AMENDMENTS NECESSARY.

_____ DEPARTMENT POSITION CHANGED TO _________________________.

__X__ REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED FEBRUARY 23, 1998, STILL APPLIES.

_____ OTHER - See comments below.

SUMMARY OF BILL

Under the Personal Income Tax Law (PITL) and the Bank and Corporation Tax Law (B&CTL), this bill would:

- provide that automobiles certified by the California Air Resources Board (CARB) as having emissions that meet or are lower than the standard for ultra-low emission vehicles (ULEV) would be depreciated over three years without regard to certain dollar limitations on the amount of depreciation that may be taken; and
- allow a taxpayer to elect to expense the total cost of the full term of a lease of an ULEV in the first year of the lease.

SUMMARY OF AMENDMENT

The proposed amendments would add the provision allowing the election to treat the total cost of the full term of a leased ULEV as an expense in the first year of the lease.

SPECIFIC FINDINGS

The specific findings contained in the analysis of the bill as introduced February 23, 1998, still apply. The discussion below relates to the provision added by the April 29, 1998, amendment.

DEPARTMENTS THAT MAY BE AFFECTED:

____ STATE MANDATE ____ GOVERNOR'S APPOINTMENT

Board Position:	Agency Secretary Position:	GOVERNOR'S OFFICE USE
____ S ____ O ____ SA ____ OUA ____ N ____ NP ____ NA ____ NAR ____X____ PENDING	____ S ____ O ____ SA ____ OUA ____ N ____ NP ____ NA ____ NAR DEFER TO ____________	Position Approved ____ Position Disapproved ____ Position Noted ____
Department/Legislative Director Date Johnnie Lou Rosas 5/14/98	Agency Secretary Date	By: Date:

In lieu of depreciation, existing **federal and state laws** allow both noncorporate and corporate taxpayers with a sufficiently small amount of expenditures on depreciable property to elect to deduct as an expense (subject to limitations) the cost of qualified property placed in service for the taxable year.

Under **federal law and state PITL**, the limit is $19,000 in 1999; $20,000 in 2000; $24,000 in 2001; $24,000 in 2002; and $25,000 in 2003 and thereafter. In general, qualifying property is defined as depreciable tangible property that is purchased for use in the active conduct of a trade or business. The allowed deduction is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000.

The B&CTL does not conform to federal expensing treatment. However, the B&CTL allows a taxpayer to deduct 20% of the cost of tangible property in the first year the property is placed in service. The maximum amount of "additional" first year depreciation is $2,000. In addition, in certain economic development areas (EDAs), corporate as well as personal income taxpayers may elect to treat the cost of qualified property within the area as an expense in the year placed in service.

Under the Personal Income Tax Law (PITL) and the Bank and Corporation Tax Law (B&CTL), **this bill** would:

- provide that automobiles certified by the California Air Resources Board (CARB) as having emissions that meet or are lower than the standard for ultra-low emission vehicles (ULEV) would be depreciated over three years without regard to certain dollar limitations in the amount of depreciation that may be taken; and
- allow a taxpayer to elect to expense the total cost of the full term of a lease of an ULEV in the first year of the lease.

Policy Considerations

This bill would create additional differences between federal and California tax law regarding depreciation, thereby increasing the complexity of completing a California tax return.

The bill applies to taxable or income years beginning on or after January 1, 1998, and before January 1, 2003. Under current federal and California law, the method of computing depreciation (including the determination of the applicable recovery period or class life) is made as of the date on which property is "placed-in-service" so that a single depreciation schedule is used for the life of the property. If the author intends the bill's provisions to apply to all ULEVs "placed in service" on or after January 1, 1998, and before January 1, 2003, then the bill will have to be amended to accomplish this intent. Department staff is available to assist the author's office with necessary amendments.

This bill would allow a taxpayer to expense, in the first year of a lease, the total cost of the full term of the lease. However, unlike other expensing provisions (such as Internal Revenue Code Section 179) and the state Manufacturer's Investment Credit, there is no recapture provision in this bill so that it is possible for a taxpayer not to complete the full term of the lease, yet be allowed to deduct more than the amount actually paid on the lease. Inclusion of a recapture provision would ensure that taxpayers are not allowed to deduct an amount greater than the expenses actually paid on the lease.

This bill does not require that only the initial lessee of a ULEV be able to expense the cost of the lease. Therefore, it is possible that the initial lessee could expense the total cost of the full term of the lease in the first year and lease the ULEV to another taxpayer, who also would be able to deduct the cost of his or her lease.

Although it appears that this bill is intended to allow a lessee to expense the cost of a lease in the first year, the bill provides the special treatment to a taxpayer, but does not state whether the expensing provision applies to a lessor who might itself be leasing from manufacturers. This should be clarified so that a single vehicle may qualify only one taxpayer to claim the expense deduction.

This bill would allow a taxpayer to expense the cost of an operating lease, which is similar to rental agreements, as well as the cost of a finance lease, which is similar to a purchase contract.

Implementation Considerations

Once the concerns below are resolved, implementing this bill would require some changes to existing tax forms and instructions and information systems, but would not significantly impact the department's programs and operations. Department staff is available to assist the author's office in resolving these concerns.

This bill would allow a taxpayer to deduct the "total cost of the full term of a lease" in the first year of the lease. However, it is unclear whether the author intends for the "total cost" to include the normal ancillary expenses such as maintenance and repairs, interest, insurance, taxes and depreciation or only the amount of scheduled lease payments attributable to capital costs or some other identifiable amount. In addition, there is also a "cost of money" (i.e. interest) element that is reflected in gross lease payments on which a taxpayer could receive an immediate deduction. Clarification of this point would help to ensure that disputes do not arise between taxpayers and department staff.

To implement this bill the FTB would need certification by the CARB that a vehicle meets the standards for ULEVs. However, this bill does not require that: CARB provide to the FTB information regarding vehicles certified as meeting ULEV standards or provide a certification to taxpayers identifying a vehicle as a ULEV; taxpayers retain a certification of a vehicle as a ULEV; or taxpayers present any certification to the FTB upon request.

Technical Considerations

Under B&CTL, this bill attempts to shorten to three years the recovery period for ULEVS. However, the B&CTL does not currently conform to IRC Section 168. For the shorter recovery period to apply to the B&CTL, either the B&CTL would need to conform to IRC Section 168 and adopt the modifications proposed in this bill, or stand alone language would need to be written. Department staff is available to assist the author's office with necessary amendments.

FISCAL IMPACT

Tax Revenue Estimate

The revenue losses under the B&CT and PIT law are estimated to be as follows:

Estimated Revenue Impact AB 2692			
Assumed Enactment After 6/30/98			
Fiscal Year Impact			
(In Millions)			
1998-9	1999-0	2000-01	2001-02
($1)	($4)	($8)	($7)

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this proposal.

Tax Revenue Discussion

This bill would decrease from five years to three years the amount of time required to depreciate qualified ultra-low emission vehicles under this bill. In addition, this bill would allow taxpayers to treat the total cost of a full term lease as an expense in the first year of the lease.

The revenue loss from this bill would depend on the number and qualified costs of ultra-low emission vehicles meeting standards and the amount of additional depreciation and expense deductions in excess of the amount that would have been allowable under current law.

The estimated losses were determined in several steps. First, the total number of qualified ultra-low emission vehicles was based on information from the California Air Resources Board (CARB), news reports regarding agreements between automakers and CARB for the production and sales of zero emission vehicles, and various other articles regarding zero emission vehicles cost and production. CARB estimates that in fiscal year 1998-9 approximately 15,000 (60,000 in fiscal year 1999-0) new vehicles will be sold in California qualifying as ultra-low emission vehicles. Second, growth rates were based on annual percentage increases, proposed by CARB to automakers, for the sale of reduced emission vehicles. Third, after determining the number of qualifying vehicles, the following data and assumptions were used: (1) 25% of qualified sales would qualify for depreciation deductions (excluding government and exempt organizations); (2) the average cost of a qualified vehicle is estimated to be approximately $30,000; (3) leased vehicles represent approximately 50% of all qualifying vehicles; (4) 50% of leased vehicles would be expensed in the first year of the lease for the full term of the lease; and (5) an average marginal tax rate of 8% was used.

Although this bill does not include a recapture provision to prevent a vehicle from qualifying more than one taxpayer for an expense deduction, it is assumed, based on conversations with the author's office, that only one taxpayer would be able to claim the expense deduction for the first year. If the bill is not amended to prevent multiple taxpayers from claiming the expense deduction, the revenue estimate would be somewhat higher.